1.10 Financial Statements for Pension Plans

Overview

Types of Pension Plans

A pension plan is an agreement between an employer and employee (the participant) to give the employee benefits once they retire. There are two main types of plans:

- **Defined Contribution Plan** – The employer and employee contribute specific amounts during the time of service, and the retired employee receives whatever sum these contributions and earnings produce (eg, 401k plan). Accounting for this type of plan is straightforward:
  - The company accrues the required contributions at the time services are rendered by employees, and reports pension expense.
  - Contributions are normally required by law to be paid before the due date of the tax return for the contribution to be deductible, so companies generally fund liabilities quickly.
- **Defined Benefit Plan** – The employer guarantees certain benefits to be paid to retired employees, and is responsible for setting aside sufficient amounts to fulfill these promises. This type of plan is far less common than a defined contribution plan these days, and accounting for them is much more complicated due to the following:
  - **Matching** – Pension expense must be recognized at the time of employee service, not when benefits are paid to retired employees.
  - **Estimation** – Costs are difficult to determine as they depend on the lifespan of employees, changes in wage rates, and the rates of return earned on investments. To compute pension expense, an *actuary* must first compute the present value (aka, actuarial present value) of the pension obligation three ways (ie, based on vested benefits, current wage rates, and future wage rates). Each computation represents the amount needed in a plan today to pay benefits to employees for service to date.

Note that the CPA Exam is no longer testing the calculation of pension cost/expense or the funded status of pension plans, so we won't be reviewing the accounting for these types of plans further. They are, however, still testing pension plan financial statements.

Required Financial Statements

There are two required financial statements (F/S) for defined contribution and defined benefit retirement plans. The purpose of these F/S is to provide information to users about the plan's ability to pay benefits.

- A statement of net assets available for benefits (as of fiscal year end)
- A statement of *changes* in net assets available for benefits (for the fiscal year)

In addition to the above F/S, a defined benefit pension plan will also provide statements or notes to the F/S regarding information about:

- The actuarial present value (APV) of accumulated plan benefits (ie, benefits expected to be paid)
- Changes in the APV of accumulated plan benefits

As with any set of F/S, **additional information** is required including:

- A statement of a plan's obligations
- A statement of changes in a plan's obligations
- Notes to the F/S

Statement of Net Assets Available for Benefits

To have funds to satisfy future retirement obligations, a pension plan must have sufficient plan assets (eg, securities, real estate). A statement of net assets available for benefits reports the net assets actually available to be used in the future to satisfy pension plan obligations. It can be thought of as the equivalent of the **balance sheet**.

The statement has two sections:

- **Plan assets** (includes any receivables related to plan assets)
    - The plan assets are generally reported at **fair value**.
    - Any investments considered to be **fully benefit-responsive**, however, are measured at **contract value**. "Fully benefit-responsive" means that the investment guarantees a certain value (ie, the contract value) to be paid to plan participants.
- **Plan liabilities** (excluding future obligations to employees)
    - Examples of liabilities include refunds for excess contributions or accrued amounts owed related to the assets.

The net assets available for benefits, when compared with the benefit obligations, indicates the financial funding status of the plan (ie, over/under-funded).

ABC Company 401(k) Plan **Statement of Net Assets Available for Benefits** *Year Ended December 31, 20X1*	
Assets:	
Investments:	
Investments at fair value	$4,424,500
Investments at contract value	1,300,000
Total investments	5,724,500
Receivables:	
Receivable for employer contribution	10,000
Receivables for participant contribution	43,000
Notes receivable from participants	250,000
Total receivables	303,000
Total assets	6,027,500
Liabilities:	
Accrued expenses	7,500
Excess contributions payable	17,500
Total liabilities	25,000
Net assets available for benefits	$6,002,500

Statement of Changes in Net Assets Available for Benefits

A statement of *changes* in net assets available for benefits reconciles the beginning balance of the plan assets to the ending balance of the plan assets. The ending balance equals the net asset available for benefits reported on the statement of net assets available for benefits. This statement can be thought of as the equivalent to an **income statement**.

ABC Company 401(k) Plan Statement of Changes In Net Assets Available for Benefits *Year Ended December 31, 20X1*	
Additions:	
Investment income:	
Interest	$ 100,000
Dividends	50,000
Net appreciation in fair value*	200,000
	350,000
Interest income on notes receivable from participants	10,000
Contributions from:	
Employer	300,000
Participants	600,000
Rollovers	100,000
	1,000,000
Total additions	1,360,000
Deductions:	
Benefits paid	350,000
Administrative expenses	7,500
Total deductions	357,500
Net increase (decrease) in assets	1,002,500
Net assets available for benefits:	
Beginning of year	5,000,000
End of year	$6,002,500

*Note that changes in market value include:

- **Unrealized gains/losses** on investments acquired during the period or held for the entire period
- **Realized gains/losses** on sales of investments, net of unrealized gains/losses previously recognized